No. 7727.

In the United States Circuit Court of Appeals

For the Ninth Circuit.

Wm. C. Kottemann,
Petitioner,

vs.

Commissioner of Internal Revenue,
Respondent.

BRIEF FOR PETITIONER.

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BRIEF FOR PETITIONER.

HISTORY AND PREVIOUS OPINION.

The Commissioner of Internal Revenue, the Respondent herein, on August 7, 1929, mailed to Petitioner a deficiency letter wherein Respondent proposed additional taxes against Petitioner for the years 1926 and 1927 in the sum of $2,878.63. [R. pp. 19 to 23.]

Within the sixty-day period Petitioner filed his appeal with the United States Board of Tax Appeals, Docket No. 45,929 [R. pp. 4 to 19], [First Amended Petition, R. pp. 24 to 27], wherein he alleged that he had, during the year 1927, obligated himself to pay the sum of $20,000.00 to attorneys, and that such liability should be accrued and taken as a deduction in determining his net taxable income. On March 6, 1934, the Board of Tax Appeals promul-

gated its opinion [R. pp. 28 to 36] and held that although Petitioner reported on the accrual basis he was entitled only to the $3,500.00 actually paid inasmuch as that was the sum that was deducted upon Petitioner's return for that year. The final order of the Board of Tax Appeals was entered on April 27, 1934. [R. pp. 36, 37.]

Jurisdiction.

Petitioner resides at Los Angeles, California, and is engaged in the practice of public accounting, being licensed to practice as a certified public accountant in the States of New York and California. Petitioner and his wife, during the year 1927, were living together and each spouse filed separate returns of income for the year 1927 with the Collector of Internal Revenue at Los Angeles, California. [R. p. 29.]

The memorandum opinion of the Board of Tax Appeals was promulgated March 6, 1934. [R. pp. 28 to 36.]

The final order of the Board of Tax Appeals was entered April 27, 1934. [R. p. 37.]

Petitioner filed his petition for review by this Honorable Court with the Clerk of the United States Board of Tax Appeals on July 23, 1934. [R. pp. 37 to 45.] This appeal was taken pursuant to the provisions of Sections 1001, 1002 and 1003 of the Act of Congress approved February 26, 1926, entitled "The Revenue Act of 1926" (44 Stat. 1, 109, 110; U. S. C. A., Sections 1224, 1225, 1226), as amended by Section 603 of the Act of Congress approved May 29, 1928, entitled "The Revenue Act of 1928" (45 Stat. 873), and as further amended by Section 1101 of the Act of Congress approved June 6, 1932, entitled "The Revenue Act of 1932." (47 Stat. 286.)

Question Involved.

Is Petitioner entitled to take as a deduction from gross income for the calendar year 1927 the entire amount of legal expenses incurred during that year in the sum of $20,000.00, or is he limited to the amount actually paid during said year of $3,500.00?

Statutes Involved.

See Appendix, pages 19 to 25.

STATEMENT OF FACTS.

Petitioner resides at Los Angeles, California, and is engaged in the practice of public accounting, being licensed to practice as a certified public accountant in the States of New York and California. Petitioner and his wife were living together during the year 1927 and each filed separate returns of income for the year 1927 with the Collector of Internal Revenue at Los Angeles, California. Petitioner for all years has consistently kept his books of account and records on the accrual basis and the returns of Petitioner and his wife were filed on that basis.

Petitioner was employed during the year 1927 to make an audit of the brokerage firm of A. C. Wagy & Company, Inc., a corporation, which was controlled by officers of the Julian Petroleum Corporation. Because of the demands for an independent audit of the stock records of the Julian Petroleum Corporation made by the First National Bank and the Pacific-Southwest Trust & Savings Bank of Los Angeles, Petitioner, on February 10, 1927, was employed to make a complete audit of the capital stock records, stock books, stock transfer books, etc. of said corporation. The

income due Petitioner as a result of this employment was placed on his books currently as it accrued and statements of the amounts due and owing from such sources were rendered to these two corporations accordingly. The audit of the Julian Petroleum Corporation was commenced on February 14, 1927, and was terminated May 16, 1927.

The audit made by Petitioner disclosed that the stock of the Julian Petroleum Corporation had been over-issued approximately six times the amount authorized by the State Corporation Commissioner of California. The over-issue was reported by Petitioner to the District Attorney of Los Angeles, California, the Board of Governors of the Los Angeles Stock Exchange, the State Corporation Department, the banks and the newspapers. Both Julian Petroleum Corporation and A. C. Wagy & Company, Inc. went into bankruptcy shortly after the overissue was exposed in May of 1927.

As a result of the disclosure of the large over-issue of stock of the Julian Petroleum Corporation, numerous investigations were instituted in the spring of 1927 by the District Attorney's office, Grand Jury and other bodies, which resulted in the indictment of a large number (approximately 100) of prominent people of the State of California, including this Petitioner. Two charges were brought, one of conspiracy to violate the State Corporate Securities Act through the over-issue of Julian Petroleum Corporation stock, and the other to defraud the public through the sale of such stock. The indictment was issued against this Petitioner on June 24, 1927, and in order to defend himself he employed the law firm of Scarborough and Bowen of Los Angeles, California. Under date of August 18, 1927, he entered into a written agreement wherein he agreed to pay these lawyers

for their services the sum of $20,000.00. The entire sum was due and payable in 1927. However, Petitioner entered on his books only $3,500.00 which he paid during said year, and which he took as a deduction on his income tax return. During the year 1928 he paid an additional $3,500.00, which he accrued on his books and took as a deduction on his income tax return filed for that year. During the year 1929 an additional sum of $6,500.00 was paid, which sum Petitioner accrued on his books, together with the balance ($6,500.00) that was still due and owing and took as a deduction on his return for said year 1929 the sum of $13,000.00.

Petitioner was tried and acquitted. Subsequently, District Attorney Asa Keyes together with his associates, who caused the indictment of this Petitioner, and others, were indicted in connection with this fiasco and charged with accepting bribes. Mr. Asa Keyes was convicted and served a term in San Quentin Prison. Although Petitioner kept his books and filed his returns on the accrual basis, he accrued only $3,500.00 of the $20,000.00 legal fee on his books in 1927 for the reason that during the latter part of said year he was negotiating with officers and attorneys of the First National Bank and the Pacific-Southwest Trust & Savings Bank of Los Angeles with the hope that said banks would stand part of this legal expense. There were some temporary assurances that something would be allowed or paid by them; therefore, Petitioner was reluctant to take the entire deduction on his 1927 return, knowing that he could subsequently file an amended return to adjust this item. The banks declined to pay any portion of this legal expense.

Had Petitioner not accepted the employment to make an audit of the Julian Petroleum Corporation stock rec-

ords, the charges would not have been made, nor the indictment found. A major part of Petitioner's income earned during said year and reported on his 1927 income tax return was fees earned and accrued on his books and records in connection with his professional duties as a certified public accountant in making the audits of the books of Julian Petroleum Corporation and A. C. Wagy & Company, Inc. The United States Board of Tax Appeals held that Petitioner was entitled to deduct from his gross income only $3,500.00 (the amount actually paid during 1927) of the $20,000.00 legal expenses incurred during the year 1927.

ASSIGNMENTS OF ERROR.

Petitioner relies upon the assignments of error set forth in his petition for review which are as follows:

1. The Board of Tax Appeals erred in failing to allow as a deduction from Petitioner's gross income for the year 1927 the entire sum of $20,000.00, legal fees incurred and which were due and payable during said year.

2. The Board of Tax Appeals erred in holding that Petitioner's items of income were all accruable, but part of his items of expense was not accruable in computing Petitioner's taxable income.

3. If the Board of Tax Appeals is correct in its determination that only $3,500.00 of the $20,000.00 legal expenses incurred in 1927 was properly accruable, then the Board erred in failing to hold that Petitioner's other items of expense and all of his items of income should have been placed on the cash receipts and disbursements basis.

4. The Board of Tax Appeals erred in failing to determine that Petitioner was entitled to a refund of at least $2,319.79 in lieu of $878.06 as determined by said Board.

LAW AND ARGUMENT.

Petitioner Is Entitled to Take as a Deduction From Taxable Income for the Year 1927 the Amount of Legal Expenses Accrued and Incurred During That Year in the Sum of $20,000.00.

The amount of Petitioner's liability to his attorneys, Messrs. Scarborough and Bowen, in the amount of $20,000.00, is undisputed, and it is admitted that the legal fees are deductible.

The only question presented in this appeal is whether or not the Petitioner is entitled to take as a deduction from gross income the entire sum of $20,000.00 representing legal expenses incurred during the year 1927 to defend himself against indictment or whether he is limited to the sum of $3,500.00 actually paid during said year.

Petitioner for all years has consistently kept his books of account and records on the accrual basis and income tax returns of Petitioner and his wife were filed on that basis. During the year 1927 Petitioner was employed to make an audit of the brokerage firm of A. C. Wagy & Company, Inc., a corporation which was controlled by officers of the Julian Petroleum Corporation. He was also employed to make an independent audit of the stock records of the Julian Petroleum Corporation. The income due Petitioner as the result of the employment was placed on his books currently as it accrued and statements of the amounts due and owing Petitioner from such sources were rendered to these two corporations accordingly. The audit made by Petitioner showed that the stock of the Julian Petroleum Corporation had been over-issued approximately six times the amount authorized by the State Corporation Commissioner of the State of California and by reason of the

disclosure of the large over-issue numerous investigations were instituted by the District Attorney's office, Grand Jury and other bodies which resulted in a large number (approximately 100) of prominent people of the State of California, including this Petitioner, being indicted. Two charges were brought, one of conspiracy to violate the State Corporate Securities Act through the over-issue of Julian Petroleum Corporation stock and the other to defraud the public through the sale of such stock. The indictment was issued against Petitioner on June 24, 1927, and in order to defend himself he employed the law firm of Scarborough and Bowen, of Los Angeles, California. Under date of August 18, 1927, he entered into a written agreement wherein he agreed to pay these lawyers for their services the sum of $20,000.00. The entire sum of $20,000.00 under this contract was all due and payable in 1927. Petitioner entered only $3,500.00 on his books which he paid during said year and only $3,500.00 was taken as a deduction upon his 1927 income tax return.

Petitioner was tried and acquitted. Subsequently, the District Attorney, Asa Keyes, together with his associates, who caused the indictment of this Petitioner and others, were indicted in connection with this fiasco and charged with accepting bribes. Keyes was convicted and served a term in San Quentin prison. Although Petitioner kept his books and filed his income tax returns on the accrual basis he accrued only $3,500.00 of the $20,000.00 legal fees on his books in 1927 for the reason that during the latter part of said year he was negotiating with officers and attorneys of the First National Bank and the Pacific-Southwest Trust & Savings Bank with the hope that said banks would stand part of the legal expense. There were some temporary assurances that something would be al-

lowed or paid by them, therefore, Petitioner was reluctant to take the entire deduction on his 1927 return, knowing that he could subsequently file an amended return to adjust this item. The banks declined to pay any portion of this legal expense.

A major part of Petitioner's income earned during the year and reported on his 1927 income tax return was fees earned and accrued on his books in connection with his professional duties as a certified public accountant in making audits of the books of Julian Petroleum Corporation and its subsidiary, A. C. Wagy & Company, Inc.

It is apparent from the record that Petitioner was a victim of unwarranted prosecution and was indicted to be kept from testifying (a co-conspirator cannot testify against another co-conspirator). The Board of Tax Appeals in its opinion [R. p. 33] found that Respondent was in error in disallowing the deduction of the sums paid to the attorneys who defended the Petitioner against indictment, stating:

> "* * * Had Petitioner not accepted the employment by Julian Petroleum Corporation the charges would not have been made nor the indictment found. As events proved, Petitioner was guilty of no wrongdoing. The case seems to come clearly within the decisions in *Kornhauser v. United States*, 276 U. S. 145; *Citron-Byer Co.*, 21 B. T. A. 308; *H. M. Howard*, 22 B. T. A. 375; *Matson Navigation Co.*, 24 B. T. A. 14."

The Board of Tax Appeals held, however, that Petitioner was entitled to deduct from his gross income for 1927 only $3,500.00, the amount actually paid in 1927. In this, Petitioner respectfully submits the Board erred by not allowing the entire $20,000.00.

Where a taxpayer is on the accrual basis the creation of a true account payable means a deduction. Assuming the item is otherwise deductible, the payable is treated as equivalent to an actual disbursement. *Rouss v. Bowers,* 30 Fed. 2d, 628 (C. C. A., 2d, 1929), Cert. Den., 279 U. S. 853, 73 L. Ed. 995, 49 Supreme Court 348 (1929). See A. R. R. 4831, C. B. III-1, p. 126; IT 1891, C. B. III-1, p. 132; IT 1272, C. B. I-1, p. 123.

Accrual of an item is a question of fact. The Board of Tax Appeals in its opinion found that Petitioner kept his books on the accrual method of accounting, subject to this one exception pertaining to legal fees incurred. The accrual system is based upon the principle that normally business obligations are in due course discharged. The theory of the method is that at the end of any accounting period all income which has been earned during the period must be accounted for as income accrued in that period, though perhaps not collected, because it is not due in the sense of collection and will not be collected until some future date and that all expenses incurred, though not paid, will be taken as a deduction in determining net income. The word "accrued" does not signify that an item is due in the sense of being payable; the accrual system disregards dates of payment (*H. H. Brown Co.,* 8 B. T. A. 112), making the right to receive and not actual receipt decisive. *Spring City Foundry Co. v. Commissioner,* 291 U. S. 656, 54 S. Ct. 527 (1934).

As long as a contract remains unbreached, the taxpayer should accrue his income receivable thereunder; the same would be true from the converse point of view with respect to deductions. Under whatever system the taxpayer makes his return the items of income and deductible expenses

must have relation to the business done within the year for which the income tax is paid. The same principles should control whether an item of income is accruable as determine whether an item of deduction is accruable. (Law of Federal Income Taxation, Vol. 1, p. 561, Paul and Mertens). One court has stated that "As to both income and deductions it is the fixation of the rights of the parties that is controlling." *Commissioner v. R. J. Darnell, Inc.*, 60 F. (2d) 82, C. C. A. 6th, 1932; *Commissioner v. Southeastern Express Co.*, 56 F. (2nd), 600 (C. C. A. 5th, 1932); *Higgins Estate*, 30 B. T. A. 814.

This statement reflects specifically a general rule which appears again and again in many decisions. Whenever a rule is given as to the accrual of income the counterpart usually appears as to deductions. Since so many recipients of fees, salaries, wages and other compensation keep their books on the accrual basis it is most important to determine when such items may be taken as an incurred deductible expense. The general rule is clear that such payments are deductible only in the year in which a fixed liability or obligation to pay is created and should relate to the income earned. The signed contract of this Petitioner certainly fixed the liability which Petitioner was bound to pay. Further, the services rendered by the attorneys had a direct bearing upon the earnings of Petitioner from the Julian Petroleum Corporation during the year 1927. It would distort Petitioner's income for 1927 unless such expense (which was part of the expense of earning and retaining the income reported by Petitioner in 1927) was allowed as a deduction. Such expense had no relation to any income subsequently earned by this Petitioner.

Unpaid liabilities may be deducted only by taxpayers on the accrual basis and they should be deducted in the year the liability is incurred. *Charles J. Kelly Estate,* 8 B. T. A. 296; *Louis de Paoli Estate,* 8 B. T. A. 294; *John E. Frymier,* 5 B. T. A. 758. The basic test whether an expense item may be accrued lies in the question whether liability is fixed. *Lucas v. American Code Co.,* 280 U. S. 445, 50 S. Ct. 202; *Brighton Mills,* 1 B. T. A. 392; *Ledbetter Manufacturing Co.,* 12 B. T. A. 145; *Adams-Roth Baking Co.,* 8 B. T. A. 458. The mere fact that a properly accrued liability is not subsequently paid does not preclude deductibility in the year of accrual if there is in the year of accrual a definite liability; thus an amount accrued and paid in 1920, as an insurance premium is a proper deductible expense of 1920 even though refunded in the following year on the cancellation of the contract. *Cohn Co.,* 12 B. T. A. 1281.

Where a petitioner's income is computed on the accrual basis obligations for legal expenses properly coming within the classification of business expense and definitely incurred in the taxable year are deductible. *U. S. v. Anderson,* 269 U. S. 422. In the case of *Searles Real Estate Trust v. Commissioner,* 25 B. T. A. 1115, the Board held that where legal expenses were incurred during the years in question for professional services rendered by an attorney and such services were connected with the earnings, such items were a proper deduction from income where income was computed on the accrual basis even though the bills were not paid because there was no available money.

Importance is sometimes attached to book entries in connection with the deductibility of accrued compensation. The book entries are evidentiary but not controlling.

Savinir Co., Inc., 9 B. T. A. 465; *Oconto Falls Motor Car Co.*, 18 B. T. A. 840; *F. J. Ross Co., Inc.*, 7 B. T. A. 196; *Henry Myer Thread Manufacturing Co.*, 2 B. T. A. 665. When it is shown that a liability for additional compensation accrued during the year it is a deduction for that year though not entered on the books or paid until a subsequent year. *Wedgewood & Sons, Ltd.*, 3 B. T. A. 355. The facts and not bookkeeping entries control in the determination of the question whether an item is income or deductible on the accrual basis. *Michigan Central Railroad Co.*, 28 B. T. A. 437; *Permanent Homes Land Co.*, 27 B. T. A. 142; *Corn Exchange Bank*, 6 B. T. A. 158. If a genuine liability has been created, or the identifiable events have occurred which give rise to liability, there will be a deductible item even though there is no entry on the books until the subsequent period. *Wolf Manufacturing Co.*, 10 B. T. A. 1161; *Borden Manufacturing Co.*, 6 B. T. A. 276.

Section 1101 of the Revenue Act of 1926 states that "The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this Act."

Article 23 of Regulations 69, in interpreting the provisions of the Revenue Act of 1926, suggests that the computation of taxable net income must be based on a system of accounting whereby all items of gross income and all deductions are treated with reasonable consistency.

Section 200 (d) of the Revenue Act of 1926 and Article 1523 of Regulations 69 make it clear that deductions must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order to clearly reflect the income such income or credits should be taken in a dif-

ferent period. It would certainly not reflect the true income of this Petitioner to take an expense incident to the earning of his fees from the Julian Petroleum Corporation in 1927 and deduct it in later years when paid inasmuch as all of the income received by this Petitioner due to such employment was reported on the accrual basis in 1927.

Since the passage of the first Income Tax Act in 1913 the Commissioner's Regulations interpreting the law provide for two principal bases for determining net taxable income, and upon which the books shall be kept and returns shall be filed. One of these is the accrual basis and the other is the cash receipts and disbursements basis. They do not provide for any mixture of the two bases. As a matter of fact, permission must be secured to change from one basis to the other. In all cases, costs and expenses which are directly comparable to the income for a period, should be included in the same period. Clearly, the purpose is to reflect the true net income respecting the period to which they apply. Obviously, where a taxpayer is on the accrual basis, commissions paid for the purpose of making a sale should properly be deductible during the period when the income from the sale is taken into account and returned as income.

In the case at bar, there was a substantial gross income during the particular period, and obviously, an expense directly applicable to that gross income should, therefore, be deductible during the same period in which the gross income was taken into account. Only by such a process can the true net income of the taxpayer be correctly reflected. That is the only fair way to determine true income.

In the case of this Petitioner, his books, records and income tax returns have consistently been on an accrual basis over a period of many years, and if the item at issue had been set up on the books during the year in which it was incurred and in which it accrued, this issue would not probably have arisen, but the reason why it was not set up on the books at that particular time has been referred to previously in this brief and is entered in the testimony of this case. The omission of that item was deliberate on the part of the Petitioner, solely because of his desire to be fair in the filing of his return and not to take advantage of his full rights in reporting his net taxable income, but rather reserving the doubt in the favor of the government pending the completion of the negotiations which were then in process relative to the bank's standing at least a part of the said legal expense. It seems unfair that Petitioner should now be penalized because of his willingness to construe all doubts in favor of the government until such doubts were cleared up. He anticipated amending his 1927 return after negotiations were completed.

In Article 112, Regulations 69, the Commissioner of Internal Revenue recognizes the right of each taxpayer to file amended returns and claim deductions for losses sustained during a prior taxable year which has not been deducted from gross income, and claim a refund of the excess tax paid by reason of the failure to deduct such loss in the original return.

If the Board of Tax Appeals is correct in its determination that only $3,500.00 of the $20,000.00 legal expenses incurred in 1927 was properly deductible, then the Board erred in failing to hold that Petitioner's other items of expense and all of his items of income should have been placed upon the cash receipts and disbursements basis.

It is submitted that the evidence conclusively shows that the liability was fixed, and inasmuch as Petitioner had consistently kept his books and filed his returns on the accrual basis the entire sum must be allowed as a deduction in order to show Petitioner's true net income. Petitioner, therefore, prays that this Court determine that he is entitled to take as a deduction for the year 1927 the entire $20,000.00 legal expense incurred during said year in lieu of the $3,500.00 actually paid.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1926.

Section 200 (d):

"The terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212 or 232. The deductions and credits provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed under section 212 or 232, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

Section 212 (b):

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *"

Section 214 (a) (1):

"(a) In computing net income there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *"

Section 1101:

"The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this Act."

Regulations 69:

"Art. 21. Meaning of net income.—The tax imposed by the statute is upon income. In the computation of the tax various classes of income must be considered:

"(a) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. Cash receipts alone do not always accurately reflect income, for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. (See sections 202-205, 208, 213, and 214 and the articles thereunder.)

"(b) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by the statute. (See section 213 and articles 31-93.)

"(c) Net income, meaning gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. (See sections 206, 214, and 215 and the articles thereunder.)

"(d) Net income less credits. (See section 216 and articles 301-306.)

"The surtax is imposed upon net income; the normal tax upon net income less credits. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory 'net income' is commercial 'net income.' This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. As to the net income of corporations, see section 232 and article 531."

"Art. 22. Computation of net income.—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as to which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 50-52.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

"Art. 23. Bases of computation.—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 for definitions of 'paid or accrued' and 'paid or incurred.' All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. (See sections 200(d) and 213 (a).) For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See articles 51 and 52.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see article 1615.)

The true income, computed under the Revenue Act of 1926 and, where the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding

year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who changes the method of accounting employed in keeping his books for the taxable year 1925 or thereafter should, before computing his income upon such new basis for purposes of taxation, secure the consent of the Commissioner. Application for permission to change the basis of the return shall be made at lease 30 days before the close of the period to be covered by the return and shall be accompanied by a statement specifying the classes of items differently treated under the two systems and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change.

Section 212 (d) contains special provisions for reporting the profit derived from the sale of property on the installment plan. (See articles 42-46.)"

"Art. 24. Methods of accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 1102 and article 1321.) * * *"

"Art. 101. Business expenses.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 121-261. * * *"

"Art. 112. When charges deductible.—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. (See articles 21-24 and 50.) The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. (But see section 206 and articles 1621-1626.) A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequent to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for re-

fund of the excess tax paid by reason of the failure to deduct such loss in the original return. (See section 284 and articles 1301-1306.) A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained.

"Art. 1523. 'Taxable year,' 'withholding agent,' 'paid or incurred,' and 'paid or accrued.'—* * * The terms 'paid or incurred' and 'paid or accrued' will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. The deductions and credits provided for in Title II must be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was 'paid or accrued' or 'paid or incurred,' he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually 'paid or incurred,' or 'paid or accrued,' as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the statute, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.